HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. ■ Ranking Democratic Member

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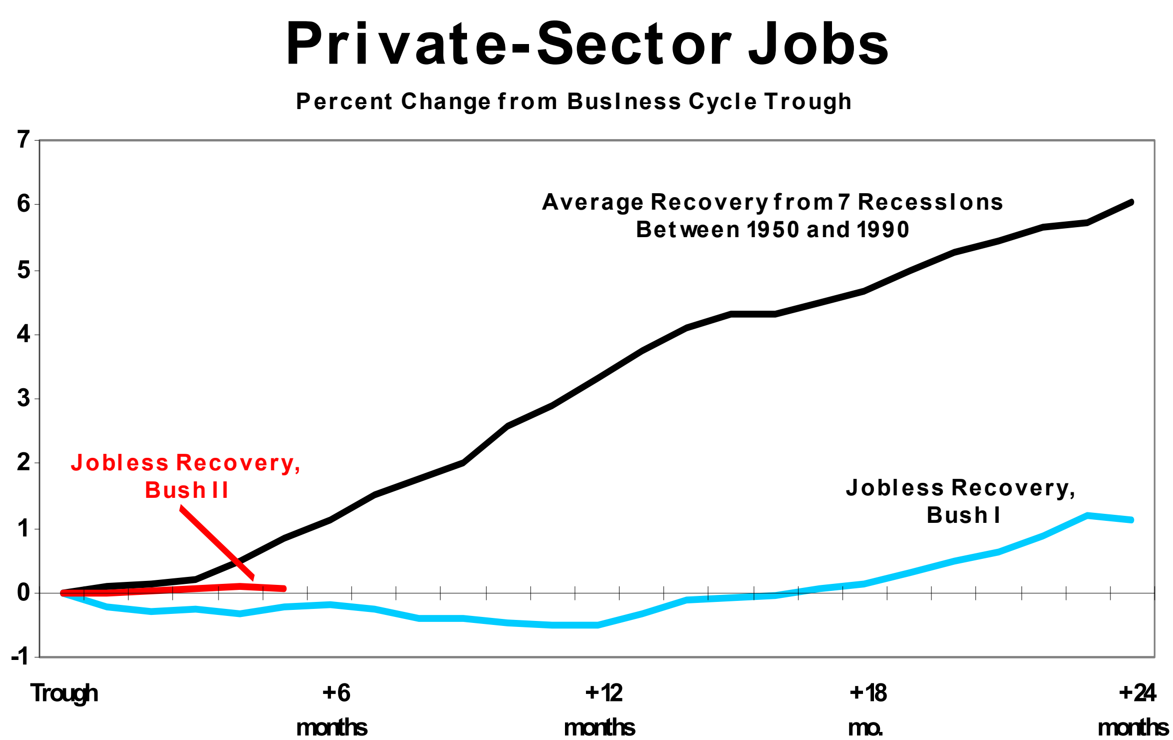
"Jobless Recovery" Would Have a Severe Impact on the Budget Outlook

Dear Democratic Colleague,

The economic recovery from the recession that began last year is thus far quite weak by historical standards. The current economic situation bears troubling similarities to the "jobless recovery" of 1991-92 that plagued the Administration of the current President's father. A reprise of those economic difficulties would result in deficits swelling beyond expectation — just as deficits ballooned to record levels 11 years ago.



The "Jobless Recovery" Thus Far

Last Friday's employment report showed that the number of jobs has increased less than one-tenth of one percent since bottoming out in April. As the chart on the first page shows, the pace of job growth is well below the rebound seen from most earlier recessions. However, the current situation is similar to the stagnation of employment after the 1990-91 recession, when the economy still had not achieved any meaningful job growth a year and a half after the economy officially bottomed out.

Data on new claims for unemployment insurance indicate that job growth could well remain stagnant in the immediate future. After dipping a bit in June and July, the four-week moving average of new jobless claims climbed above 400,000 per week in the last seven weeks. This indicates that the pace of job loss recently is about where it was at the beginning of the year, and that opportunities for new jobs are scarce. The fact that long-term joblessness (unemployed more than 15 weeks) has more than doubled over the course of this year — jumping from 1.3 million to 2.9 million — also indicates that new job opportunities are scant.

Some may argue that the recovery is more robust than the jobs data suggest, because real GDP has grown over the last three quarters at a 3.0 percent annual rate. This is misleading. The economy typically posts unusually strong productivity gains just as it stops falling, because firms that previously had reduced their workforces pick up the pace for existing employees before hiring new ones. Such above-trend productivity gains cannot continue for long, and growth of real GDP growth will surely slow if employment gains remain muted in coming months.

The Recovery May Well Remain Weak for Some Time

The primary source of economic weakness presently is business investment, which has fallen in real terms for the last seven consecutive quarters and shows little prospect of improvement. Firms are reluctant to invest for the future as long as they believe that government borrowing is out of control and will weigh upon credit markets for years to come. Furthermore, the pace at which businesses added new plant and equipment in the late 1990s was so strong that many forecasters believe it will take some time before firms are again eager to add to capacity.

In the previous "jobless recovery" of 1991-92, the economy failed to recover for more than a year because it was held back by economic "headwinds" (to use Fed Chairman Alan Greenspan's terminology of the time). These "headwinds" were largely related to financial turmoil in the aftermath of the savings and loan crisis, when the financial system had to digest hundreds of billions of dollars of bad loans and failed real estate investments.

Unfortunately, the economy may be suffering from similar headwinds now. Financial markets are again in turmoil, this time in the aftermath of a speculative bubble in the stock market. And, this stock market decline has coincided with a similar collapse in real business investment.

The huge decline of the stock prices and the worsening budget outlook also is likely to curb consumers' spending for some time, just as they will inhibit businesses from making new investments or other financial commitments. Something like $8 trillion in stock market wealth has evaporated with the market's decline, and that will make consumers less willing to spend. Stock price declines have been so steep that, even with a market rebound, it will be years before consumers feel as wealthy as they did two years ago.

On top of this, consumers also are burdened with considerable uncertainty about the future. Both the abrupt deterioration of the budget outlook and continued high energy prices may weigh upon households' enthusiasm for major commitments in coming months.

If Growth Is Weaker Than Predicted, Then Deficits Will Be Larger Than Predicted

Some argue that the budget will be fine as soon as the economy recovers. But the economic forecast that underlies the Administration's claim that we will realize unified budget surpluses three years from now already posits quite strong growth over that period. That prediction may prove unattainable if the jobless recovery persists.

To achieve the 3.7 percent real GDP growth in 2002 that underlies the Administration's budget projections, the economy will have to climb at an annual rate exceeding 4.0 percent in the last two quarters of the year. Growth in the third quarter (to be reported on October 31) may well match this pace. However, prospects for fourth quarter growth are cloudy, given the rise in jobless claims, continuing stock market weakness, a slumping manufacturing sector, high office vacancy rates, and sagging consumer confidence.

Even if we manage GDP growth in 2002 at the rate the President's budget assumes, it seems unlikely that the economy will advance at the muscular pace the Administration predicts for the next three years. OMB projects that real GDP will grow at 3.7 percent in 2003, at 3.5 percent in 2004, and at 3.4 percent in 2005. These rates are about half a percentage point faster than CBO assumes, and OMB's ten-year budget projections are more than $1.0 trillion more optimistic partly as a result.

Of course, if we repeat the "jobless recovery" experience of 11 years ago, then even CBO's budget projections will prove too optimistic. In the two years following the trough of the 1990-91 recession, the economy grew at only a 2.7 percent rate. A repeat of that experience would reduce the projected ten-year surplus by several hundred billion dollars below what CBO currently projects. If we also suffered further downward revisions of the projected surplus like those seen this year related to the weak stock market, the nation would face substantial unified deficits for at least the next decade.

Republicans Have No Plan to Remedy the "Jobless Recovery"

There is considerable danger that the economy will manage only grudging growth now, even if it avoids sliding back into recession. The impact of the stock market's plunge on new business investment and consumer spending will play out for some time. In addition, the return of chronic budget deficits has added greatly to the uncertainty plaguing consumers' and businesses' economic decisions about the economy's future path.

It is, therefore, troubling that the President and his Republican allies in Congress can think of nothing to do about these risks other than to propose additional tax cuts — most of which would take effect in 2011, nine years from now. The economic and budget outlook has changed dramatically for the worse, but the Republican agenda remains unchanged.

At some point, the Administration and its Congressional allies will be obliged to acknowledge that there is a problem, and that their approach has not worked. Until that time, no progress is possible. But once that happens, Democrats will welcome the opportunity to sit down with them to negotiate an economic and budget plan based on national unity, foresight and proven policies.

Sincerely,

John M. Spratt, Jr.
Ranking Member